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CM#31

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 18, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: MARC E. LELAND
ASSISTANT SECRETARY
INTERNATIONAL AFFAIRS

SUBJECT Eastern European and Yugoslavia's Debt Situation

At year-end 1981 the gross debt of the Eastern European countries, excluding Yugoslavia, totaled nearly $67.6 billion, an increase of about 4 percent over a year earlier. Poland ($26 billion) and Romania ($10.7 billion), which account for nearly 54 percent of the total, are already seeking to reschedule their 1982 debt service obligations. The external debt situations in East Germany ($14.5 billion) and Hungary ($9.1 billion), are also serious. Only in the case of Czechoslavakia and Bulgaria, among the Eastern European countries, is it clear that there will be no need for a debt rescheduling in 1982. Although Yugoslavia is not part of the Warsaw Pact, and should be considered in a separate context from the Eastern European countries, its debt situation is also reviewed in this memo.

Poland

Poland's economic situation has deteriorated since the imposition of martial law on December 13, 1981. Industrial production is down largely because of idle capacity (estimated at about 40 percent) resulting from shortages of western imports. The shortages of western imports are largely attributable to the cut-off of financial assistance from the West. Without western credits Poland is on a "cash and carry" basis with imports being limited to a portion of the amount of hard currency they can earn. In 1982, Polish exports and invisible earnings are estimated to total about $6.5 billion.

The official 1981 rescheduling agreements have been concluded but Poland has not completed paying the non-rescheduled portion to the U.S., French and Italian Governments. In addition, the Poles are in arrears to official creditors on interest payments due in 1982 on their consolidated 1981 obligations. The official creditors are still

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refusing to enter into rescheduling discussions on the 1982 obligations until the Polish regime (1) releases the prisoners, (2) relaxes martial law and (3) resumes discussions with the church and Solidarity.

The private creditors have apparently concluded their 1981 rescheduling agreement with the Polish payment of all outstanding 1981 interest obligations as well as the interest on the consolidated 1981 debt.

In 1982, Poland's medium and long term debt service obligations will total about $10.5 billion. Principal payments to official and private creditors will amount to an estimated $6.8 billion and interest payments (including interest on the 1981 reschedulings) to about $3.7 billion. If Poland's 1982 debt service obligations were rescheduled on the same terms as in 1981, the Poles would still need another $3.4 billion of credits.

The existing financial situation in Poland cannot continue indefinitely. Arrearages on 1982 debt obligations are increasing by about $800 million each month. The longer this continues the greater the likelihood that (1) a private creditor, probably a small bank, will break ranks and formally declare Poland in default in an effort to attach Polish assets or (2) the smaller official creditors (Switzerland, Austria, Sweden) will break ranks and reschedule their 1982 debt. In the latter case, the Poles will probably pay the non-rescheduled portion of their debt to those countries who do reschedule and, in effect, have a 100 percent "rescheduling" from the others by continuing not to pay them.

Romania

As a result of a combination of adverse external developments and its financial mismanagement, the GOR fell into arrears last year by more than $1 billion on its commercial credits, despite a relatively low debt service ratio of about 21 percent. The adverse external developments included the earlier rise in oil prices and a reluctance on the part of western banks to extend further credit in the wake of the Polish situation. These problems were compounded by the GOR's having accumulated large amounts of short-term debt: At the end of 1980, its total hard currency debt was $9.6 billion, of which $2.1 billion was short-term; its total debt had risen to $10.1 billion by the end of 1981, with a short-term component of $643 million.

Since last fall, the Romanians have been struggling on a number of fronts to straighten out their financial situation:

-- When they went into arrears, the Romanians violated a condition of their standby program with the IMF; as a consequence, their access to the Fund's resources was suspended. They recently reached agreement on a 1982 program with the Fund staff which will come before the Board for decision on May 28. The staff is proposing that the standby be approved but that Romania's access to IMF funds this year be made contingent on a rescheduling by all of its major creditors.

-- After consulting privately with 9 of its major bank creditors, the GOR sent a telex to all of its bank creditors notifying them that it was declaring a moratorium on debt repayments and proposing a rescheduling of $2.4 billion (80 percent of its 1981 arrearages plus 1982 repayments). Discussions with the banks are proceeding.

-- They have asked for a Paris Club rescheduling of and recently extended their moratorium to their official debt of $1.7 billion (of which about $300 million is owed to the U.S. Government).

-- They have been rebuffed on their request to the Soviets and some Arab countries for a rescheduling.

The United States has conditioned its participation in the Paris Club process for Romania on an agreement on an IMF standby program and some progress toward an agreement to restrain official credits to the USSR. No determination will be made until after the Summit and after review and approval of the IMF program.

Hungary

Economic growth was only slightly positive in 1981 because agricultural production declined and the regime cut western imports in order to balance its external accounts. In 1982 and for the next several years living standards will be subordinated to the goal of maintaining external balance. The Hungarians hope to improve their performance with reform measures designed to foster efficiency, expand enterprise autonomy, phase out subsidies, and bring domestic prices closer to world prices. Implementation of the reforms has been inhibited, however, by consumer resistance to austerity, bureaucratic opposition, and the hard currency credit crunch facing all of Eastern Europe.

Hungary recorded its third consecutive trade surplus in 1981, but interest charges pushed the current account into a $600 million deficit. A $500 million current account deficit is projected for this year even though the Hungarians are continuing to rein in their imports.

Until the borrowing environment improves, the Hungarians hope economic reforms as well as industrial and agricultural exports will help to lower their current account deficit. They have raised $220 million in credit through the BIS to increase their reserves, which had been sharply reduced in the first quarter of 1982 by Soviet, Western and Arab bank withdrawals of their deposits in the Hungarian National Bank. It is possible that at some point during the year Hungary may also seek financing from the IMF, although their intentions are unclear at this point.

Yugoslavia

Developments in Yugoslavia's economy in 1981 were mixed. Its current account deficit declined from $2.2 billion in 1980 to $1.3 billion in 1981 (below its $1.8 billion target). However, despite reductions in real domestic demand and fixed investment as well as GOY adherence to monetary and credit targets, retail prices increased by 39 percent rather than the planned 20-25 percent. The annual plan for 1982, which was incorporated into Yugoslavia's IMF standby agreement, projects reductions in the current account deficit to $0.5 billion and the rate of inflation to 15 percent. The GOY has recognized that the inflation target will not be met. A 20-25 percent rate now appears more likely.

To meet its current account targets in 1982, Yugoslavia expects to increase its hard currency exports by 12 percent in volume. As OECD imports are projected to rise by only 5-6 percent in volume during 1982, this goal will be difficult. Thus, the GOY's forecasted global financing requirements of $3.3 billion in 1982 ($1.7 billion in trade financing and $1.6 billion in financial credits) may be too low.

Western bankers are unwilling to provide additional medium-term financing at present. Yugoslavia's hard currency reserves could therefore be seriously depleted if western banks cut back on short term roll overs and the increased hard currency exports do not materialize as expected. Under these circumstances, a rescheduling would become increasingly likely. (Yugoslavia's total debt was $18.4 billion at the end of FY 1981.)

Should such a liquidity squeeze in fact occur, western governments could be called upon to provide financial assistance to help Yugosalvia overcome its problems. The United States would be expected to participate in any such effort.

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